In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 583

D. B. ANDERS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. A3–A17) are reported at 48 T.C. 815. The opinion of the court of appeals (Pet. A18–A27) and the court's order denying the petition for rehearing (Pet. A28–A31) are not yet officially reported.

JURISDICTION

The judgment of the court of appeals was entered on June 20, 1969, and its order denying the petition for rehearing was entered on August 6, 1969. The petition for a writ of certiorari was filed on Septem-

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ber 12, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, upon a sale of corporate assets preceding a complete liquidation under Section 337 of the Internal Revenue Code, the amount received for rental items, the cost of which had previously been deducted from ordinary income, is taxable as ordinary income under the tax benefit rule.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Section 337 of the Internal Revenue Code of 1954 and Section 1.337–3 of Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*, pp. 9–10.

STATEMENT

Service Industrial Cleaners, Inc. ("Service") was engaged in the business of providing a rental service of laundered towels, seat covers, wiping and dusting materials and various items of apparel. These items had a useful life of 12 to 18 months or somewhat longer depending on the use made of them. Service also carried on a general cleaning and laundering business for such items owned by others and an industrial laundry business. (Pet. A19.)

For federal income tax purposes Service charged the full cost of the rental items to its expense accounts at the time of acquisition. At the end of its tax years the expense accounts were credited with the cost of items not placed in service during the year,

with the result that Service obtained a current deduction for all items that had been placed in service during the year. There is no dispute as to the propriety of these procedures. (Pet. A19–A20.)

In May, 1961, petitioner, the owner of Service's stock, entered into an agreement for the sale of the business and properties of Service. Service's directors and stockholders approved the terms of sale and adopted a plan of complete liquidation pursuant to Section 337 of the Internal Revenue Code of 1954 (Appendix, *infra*, pp. 9–10). In accordance with the above, the rental items and substantially all of Service's assets were sold to the purchasers.[1] (Pet. A20.)

In the terms of sale Service agreed with the purchasers on the specific consideration to be paid for the inventory of rental items and also for furniture, realty, goodwill and accounts receivable. Service reported a gain of $446,601 on the sale and claimed nonrecognition of this gain under Section 337. The gain included $233,000 received for the rental items in use, the cost of which had previously been deducted from ordinary income. The government contended that the $233,000 should be taxed as ordinary income under the tax benefit rule since the rental items had been charged to expense on purchase and deducted (Pet. A20–A21). The Tax Court held that the $233,000

[1] There is no dispute as to Service's compliance with the requirements of Section 337 for a complete liquidation. Moreover, the parties agree that the rental items were not stock in trade or property includible in inventory or held for sale to customers, within the meaning of Section 337(b)(1)(A) of the 1954 Code. (Pet. A20.)

constituted nonrecognizable (and therefore nontaxable) gain under Section 337 (Pet. A9–A17), and the court of appeals reversed (Pet. A18–A27, A28–A31).

ARGUMENT

The decision of the court of appeals is correct; there is no conflict of decisions, and no other occasion for further review by this Court.

1. Section 337(a) of the Internal Revenue Code provides generally for the nonrecognition of gain realized from the sale of "property" in connection with certain liquidations. Section 337(b) sets forth certain categories of "property" excepted from the Section 337 (b) definition of that term, the gain on the sale of which is recognizable. Although Section 337(b) does not specifically refer to the tax benefit rule, the court of appeals correctly concluded (Pet. A24) that there was "no provision in the statute showing an intent to alter or bar the application in cases under Section 337 of tax benefit principles fashioned under other provisions of the Code." Accordingly, the court below held that the proceeds from the disposition of the previously expensed rental items should be treated as ordinary income. In so holding, it rejected petitioner's contention to the effect that the tax benefit rule did not apply here because the rental items in question fell literally within the general meaning of "property" in Section 337.

2. The decision of the court of appeals is consistent with the tax benefit rule,[2] as applied by this Court and

[2] The tax benefit rule was first developed through court decisions and was subsequently added to the Code itself. See

other courts, the rationale of which is that if an item has previously served to offset taxable income, its recoupment should be treated as a recovery of income. *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 686 n. 5; *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399, 401–403 (Ct. Cl.); *O'Meara* v. *Commissioner*, 8 T.C. 622, 634–635. Specifically, the tax benefit rule has been held to require the restoration to income of accrued deductions which are subsequently recovered in the very situation presented here, *viz.*, a corporation selling all of its assets and liquidating under Section 337. The decision below thus follows other cases recognizing that the policy of the tax benefit rule is applicable to a liquidating corporation, notwithstanding its qualification under the nonrecognition of gain provisions of Section 337. *West Seattle National Bank of Seattle* v. *Commissioner*, 288 F. 2d 47 (C.A. 9); *Citizens Federal S. & L. Ass'n of Cleveland* v. *United States*, 290 F. 2d 932, 936–938 (Ct. Cl.)[3] Petitioner has cited no court of

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Section 111 of the 1954 Code. While that provision refers only to the recovery of certain items, such as bad debts, prior taxes or delinquency amounts, Section 1.111–1 of the Treasury Regulations extends the rule to the recovery of other deducted items. The Regulations are valid as a clarifying interpretation of the Code provision. See 1 Mertens, *Law of Federal Income Taxation* (Rev.), Sections 7.34, 7.37, pp. 84–86, 95. See also *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399, 402–403 (Ct. Cl.); *Monday* v. *Commissioner*, decided January 2, 1957 (P–H Memo T.C., par. 57,001), affirmed *per curiam*, 252 F. 2d 789 (C.A. 6), certiorari denied, 358 U.S. 883; *Faidley* v. *Commissioner*, 8 T.C. 1170.

[3] The issue in this case is to be contrasted with the question presented in *Nash* v. *United States*, 414 F. 2d 627 (C.A. 5), pending on taxpayers' petition for certiorari, No. 678, this Term,

appeals decision to the contrary, and we are unaware of any such decision.[4]

3. The decision of the court of appeals also is consistent with the purpose of Section 337. Petitioner's contention (Pet. 9–14) that the tax benefit rule does not apply in Section 337 cases necessarily rests upon a literal definition of the term "property" in the statute. It fails to recognize, as the court below held (Pet. A23–A24), that the gain from the sale of property to which Section 337 accords nonrecognition treatment is gain which otherwise would be taxed at capital gains rates.[5] Since the gain that would be

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in which the government has acquiesced. The issue in *Nash* is whether a partnership's unused reserve for bad debts is required to be restored to income upon the transfer of all of its assets to a controlled corporation in exchange for stock under Section 351 of the Code. Unlike the instant case where there was a sale of corporate assets at fair market value to an unrelated third party, *Nash* involves a transfer of assets to a corporation, the shareholders of which were members of the partnership which previously held the assets. See *Estate of Schmidt* v. *Commissioner*, 355 F. 2d 111, 113–114 (C.A. 9).

[4] None of the cases referred to by petitioner (Pet. 7–8) have been decided, except *Spitalny* v. *United States*, 288 F. Supp. 650 (D. Ariz.), in which the district court held that a corporation could treat the amount received from the sale of feed and other supplies on hand in a liquidating sale as nonrecognizable gain under Section 337. An appeal has been filed by the United States to the Ninth Circuit. The case awaits argument and decision in the court of appeals.

[5] The history underlying the enactment of Section 337 demonstrates that it was designed to eliminate the double incidence of capital gains taxation on a sale of assets by a liquidating corporation—once when the corporation sold its assets and again on distribution of the proceeds to its shareholders in liquidation. The old rule required such double taxation when the sale was accomplished by the corporation rather than the shareholders. See H. Rep. No. 1337, 83d Cong., 2d Sess., p. A106

realized upon a disposition of the rental items in question would be considered ordinary income (because the cost of the items had previously been deducted from ordinary income), such gain cannot qualify for nonrecognition treatment under Section 337. See *Williamson* v. *United States*, 292 F. 2d 524 (Ct. Cl.); *Commissioner* v. *Kuckenberg*, 309 F. 2d 202 (C.A. 9); *Family Record Plan, Inc.* v. *Commissioner*, 309 F. 2d 209 (C.A. 9).[6]

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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(3 U.S.C. Cong. & Adm. News (1954) 4017, 4244); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 258 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4896). Compare *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 with *United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451.

[6] Petitioner's reliance (Pet. 17) on the Commissioner's ruling (Rev. Rul. 59-308, 1959-2 Cum. Bull. 308) relating to amortized emergency facilities is misplaced. As the court of appeals observed (Pet. App. A26), the expensing of rental items cannot be equated with the gradual exhaustion of an asset. Moreover, the question of the treatment of depreciation under Section 337 has largely been mooted by the enactment in 1962 of Section 1245 of the Code (Pet. App. A26 n. 7).

APPENDIX

Internal Revenue Code of 1954:

SEC. 337. GAIN OR LOSS ON SALES OR EXCHANGES IN CONNECTION WITH CERTAIN LIQUIDATIONS.

(a) *General Rule.*—If—

(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

(b) *Property Defined.*—

(1) *In general.*—For purposes of subsection (a), the term "property" does not include—

(A) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year, and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business,

(B) installment obligations acquired in respect of the sale or exchange * * * of stock in trade or other property described in subparagraph (A) of this paragraph, and

(C) installment obligations acquired in respect of property (other than prop-

erty described in subparagraph (A)) sold or exchanged before the date of the adoption of such plan of liquidation.

(2) *Nonrecognition with respect to inventory in certain cases.*—Notwithstanding paragraph (1) of this subsection, if substantially all of the property described in subparagraph (A) of such paragraph (1) which is attributable to a trade or business of the corporation is, in accordance with this section, sold or exchanged to one person in one transaction, then for purposes of subsection (a) the term "property" includes—

(A) such property so sold or exchanged, and

(B) installment obligations acquired in respect of such sale or exchange.

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(26 U.S.C. 337.)

Treasury Regulations on Income Tax (1954 Code):

Sec. 1.337–3. PROPERTY DEFINED.

(a) Except as provided in section 337(b)(2) and this section, the term "property" as used in section 337(a) and § 1.337–1 does not include, (1) stock in trade of the corporation, or other property of a kind which would properly be included in the inventory of the corporation if on hand at the close of the taxable year and property held by the corporation primarily for sale to customers in the ordinary course of its trade or business (hereinafter for purposes of section 337 referred to as "inventory"), (2) installment obligations acquired at any time from the sale or exchange of inventory, or (3) installment obligations acquired from the sale or exchange of property (other than inventory) prior to the adoption of the plan of liquidation. With the exceptions listed in this paragraph the term "property" includes all assets owned by a corporation.

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(26 C.F.R. 1.337–3.)

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